

## **Production of Information Contained in Litigation Reserves**

In this month's newsletter, IADC member Bruce Barze and his colleagues, Greg Cook and Marcus Chatterton, discuss the protection of litigation reserves under the attorney-client privilege and the work product doctrine, particularly in light of proposed changes to FASB Statement No. 5.

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The purpose of this article is to identify strategies for protecting sensitive information that may be contained in litigation reserves. The first part of this article will discuss the applicability of the attorney-client privilege and the work-product doctrine to litigation reserves. The second part discusses the waiver or preservation of these protections when litigation reserves are disclosed to outside auditors, internal auditors, and parent corporations. The third part makes some practical suggestions—based on the current state of the law—for invoking and preserving those protections.

These issues have become more pressing because the Financial Accounting Standards Board ("FASB") recently proposed a set of far reaching changes to FASB Statement No. 5 that would lower the disclosure threshold in some cases and increase substantially the amount of information that would need to be disclosed.<sup>1</sup>

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<sup>1</sup> The FASB draft may be found at [www.fasb.org/draft/ed\\_contingencies.pdf](http://www.fasb.org/draft/ed_contingencies.pdf). Under the revised rule, public companies would need to disclose all loss contingencies unless the chance of loss is "remote." Even "remote" contingencies would need to be disclosed if the matter was likely to be resolved in the next year and could have a "severe impact" (that is "significantly financially disruptive" effect) on the company. Both the quantitative and qualitative disclosures would change. The proposed amendment would require the amount of the claim (or if none is made, then the company's "best estimate of the maximum exposure to loss." Further, the disclosure would need to include: "a description of the contingency, how it arose, its legal or contractual basis, its current status, and the anticipated timing of its resolution; a description of the factors that are likely to affect the ultimate outcome of the contingency along with their potential effect on the outcome; the entities' qualitative assessment of the most likely outcome of the contingency; and significant assumptions made by the entity in estimating the amount disclosed." Further, there must be a quantitative and qualitative assessment of relevant insurance and indemnification agreements. In addition to changing Standard 5 (known as "Accounting for Contingencies"), the proposed amendment would also change FAS 141(R) which deals with loss contingencies in business combinations. The FASB has received a large number of detailed comments on this draft (for instance, the American Bar Association and the Chamber of Commerce) and it would seem unlikely that the FASB would act without additional revisions and comments. Nevertheless, it would appear likely that some increased disclosure may be required.

**Part I – Protecting Litigation Reserves**

A “litigation reserve” is a portion of a corporation’s retained earnings that are set aside for the express purpose of satisfying legal judgments expected to accrue against the corporation within a particular time period. The actual amount of the reserve is determined by the corporation’s leadership, but it is based to varying degrees on an assessment by the corporation’s lawyers of the value and probable outcome of claims pending against the corporation. Factors considered in setting a litigation reserve include the strength of the claims against the corporation, legal obstacles to pursuing or defending against the claims, and the likelihood of settling those claims without a trial. Often, the corporation’s lawyers—whether in-house or outside—are requested expected to provide some form of assessment of the corporation’s litigation exposure for use in establishing and maintaining an adequate litigation reserve. Precisely because litigation reserves are based (at least in part) on a lawyer’s assessment of the “value” of a case against the corporation, documents describing or explaining a litigation reserve may be highly prized by an opponent of the corporation and might even be argued as an admission against interest.<sup>2</sup>

For the purposes of this article, a “litigation reserve” includes any document generated by a corporation, or by the corporation’s lawyers, referencing, describing, justifying, or establishing the amount of reserve for an individual case or for the corporation’s litigation reserve fund. There are two general avenues to protect litigation reserves from discovery: (1) the attorney-client privilege and (2) the work-product doctrine.

***A. The Attorney-Client Privilege***

The attorney-client privilege protects confidential communications between a lawyer and client. “The party invoking the attorney-client privilege has the burden of proving that an attorney-client relationship existed and that the particular communications were confidential. To determine if a particular communication is confidential and protected by the attorney-client privilege, the privilege holder must prove the communication was (1) intended to remain confidential and (2) under the circumstances was reasonably expected and understood to be confidential.”<sup>3</sup> The privilege, of course, covers only those confidential communications made for the primary purpose of rendering legal advice; communications

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<sup>2</sup> See, e.g., Matthew J. Barrett, *Opportunities for Obtaining and Using Litigation Reserves and Disclosures*, 63 OHIO ST. L.J. 1017 (2003) (encouraging “savvy litigators” to “use the discovery process to obtain very helpful data about litigation reserves or contingencies related to an underlying lawsuit.”); See also *Frank Betz Assoc. v. Jim Walter Homes, Inc.*, 226 F.R.D. 533 (D. S.C. 2005) (“The plaintiff seeks discovery on the amount of a ‘reserve’ that was set aside for purposes of this litigation.”).

<sup>3</sup> *Bogle v. McClure*, 332 F.3d 1347, 1358 (11th Cir. 2003).

made for other purposes, *e.g.* business purposes, are not protected.<sup>4</sup> However, the U.S. Supreme Court made it clear in *Upjohn Co. v. United States* that communications between the lawyer and client that discuss business matters are probably still protected—as long as they are made for the purpose of facilitating the legal advice.<sup>5</sup>

Communications made in the presence of others are usually not considered confidential. Complications arise in the corporate setting, because the “client” is the corporation itself which is usually made up of many people. Further, the presence of multiple persons (officers, directors, and sometimes ordinary employees) may be necessary to effectuate the rendering of legal advice to the corporation. Federal courts apply the *Upjohn* test to determine which employees/agents of the corporation may be involved in the communication with counsel while maintaining the privilege. *Upjohn* provides, in essence, that privilege extends to confidential communications between corporate counsel and (1) the executives who “control” the actions of the

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<sup>4</sup> See, *e.g.*, *Int’l Tel. & Tel. Corp. v. United Tel. Co.*, 60 F.R.D. 177, 185 (M.D. Fla. 1973) (“The mere attendance of an attorney at a meeting, even where the meeting is held at the attorney’s insistence, does not render everything done or said at that meeting privileged. For communications at such a meeting to be privileged, they must have related to the acquisition or rendition of professional legal services and must have retained a confidential character.”)

<sup>5</sup> 449 U.S. 383, 390 (1981) (“The privilege exists to protect not only the giving of professional advice to those who can act on it, but also the giving of information to the lawyer to enable him to give sound and informed advice.”)

corporation, and (2) other corporate employees/agents whose input or information is necessary to (a) evaluate whether certain conduct has bound or would bind the corporation, (b) aid counsel in assessing the legal consequences of an act taken on behalf of the corporation, or (c) formulate an appropriate legal response to actions that effect the corporation.<sup>6</sup>

Some state courts still apply older tests that limit the privilege to communications directed to employees in the “control group” of the corporation, or limit the privilege by requiring that the “subject matter” of the communication be related to the seeking or rendering of legal advice to the corporation.<sup>7</sup>

### ***B. Internal Communications On Reserves Qualify***

Regardless of which test is applied, it is likely that communications regarding litigation reserves will fall within the ambit of the attorney-client privilege. Such communications might reasonably involve a corporation’s financial officer, accountant, analyst, and others necessary to the corporate decision-making process besides the counsel. Because all of these people are needed to allow the lawyer to render the legal advice requested by the corporation, the discussions are likely privileged. At the very least, discussions or written communications between counsel and the corporate “leadership” regarding the likely outcome of pending litigation will be protected under any formulation of the corporate attorney-client privilege.

For example, in *United States v. Textron, Inc.*, the federal district court for Rhode Island held that the attorney-client privilege applied to “tax accrual workpapers” that discussed litigation reserves:

since the tax accrual workpapers of Textron and TFC essentially consist of nothing more than counsel’s opinions regarding items that might be challenged because they involve areas in which the law is uncertain and counsel’s assessment ... in any ensuing litigation, they are protected by the attorney-client privilege.<sup>8</sup>

While it would appear that the attorney-client privilege applies to litigation reserves, that privilege is easily waived. As discussed below, virtually any disclosure of the information to someone outside of the client-attorney relationship may result in a complete and

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<sup>6</sup> *Id.*

<sup>7</sup> See generally EDNA SELAN EPSTEIN, THE ATTORNEY-CLIENT PRIVILEGE AND THE WORK-PRODUCT DOCTRINE, 175 (American Bar Ass’n, 5th ed. 2007).

<sup>8</sup> 507 F. Supp. 2d 138, 147 (D.R.I. 2007).

permanent waiver of the attorney-client privilege.

### ***C. Work-Product Doctrine***

The work-product doctrine may provide more durable protection for litigation reserves. First established in *Hickman v. Taylor*,<sup>9</sup> and later codified in the Federal Rules of Civil Procedure and analogous state rules, the doctrine protects documents and tangible things “prepared in anticipation of litigation or for trial by or for [a party to a lawsuit] or by or for [its] representative (including [its] attorney, consultant, surety, indemnitor, insurer, or agent).”<sup>10</sup> Special protection is afforded to the mental operations of a lawyer.<sup>11</sup>

Although the protection of the work-product doctrine is not as absolute as a privilege, it tends to be much more durable because there is no confidentiality requirement. As the First Circuit explained in the leading case of *United States v. MIT*:

[W]ork-product protection is not as easily waived as the attorney-client privilege. The privilege, it is said, is designed to protect confidentiality, so that any disclosure outside the magic circle is inconsistent with the privilege; by contrast, work-product protection is provided against “adversaries,” so only disclosing material in a way inconsistent with keeping it from an adversary waives work-product protection.<sup>12</sup>

### ***D. Are Reserves Created “In Anticipation of Litigation?”***

The problem with work-product protection for litigation reserves is that the reserves are not prepared directly for use at trial—they are actually prepared for business-planning or compliance purposes. Thus, the key to obtaining work-product protection is the interpretation of the phrase “in anticipation of litigation.” Most courts interpret this phrase using what has come to be known as the “because of” test. For example, the Second Circuit wrote in *United States v. Adlman*: “[D]ocuments should be deemed prepared ‘in anticipation of litigation,’ and thus within the scope of the Rule, if ‘in light of the nature of the document and the factual situation in the particular case, the document can fairly be

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<sup>9</sup> 329 US 495 (1947).

<sup>10</sup> FRCP 26(b)(3) (emphasis added); accord Ala. R. Civ. P. 26(b)(3) (*committee comments on 1973 adoption*) (“The rule of *Hickman* is no stranger to Alabama, having been recognized and applied in *Ex parte Alabama Power Co.*, 280 Ala. 586 (1967).”).

<sup>11</sup> See FRCP 26(b)(3) (“In ordering discovery of such materials when the required showing has been made, the court shall protect against disclosure of the mental impressions, conclusions, opinions, or legal theories of an attorney or other representative of a party concerning the litigation.”); See also Ala. R. Civ. P. 26(b)(3) (*committee comments on 1973 adoption*) (The work-product doctrine “gives absolute protection to an attorney’s mental impressions, legal theories, and the like.”).

<sup>12</sup> 129 F.3d 681 (1st Cir. 1997).

said to have been prepared or obtained *because of* the prospect of litigation.”<sup>13</sup>

Courts applying the “because of” test have almost uniformly protected litigation reserves (and similar items like tax accrual workpapers) under the work-product doctrine.<sup>14</sup> For example, in *Simon v. G.D. Searle & Co.*, the Eighth Circuit applied the “because of” standard to risk management documents prepared by “non-lawyer corporate officials” that referenced “individual case reserves calculated by Searle’s attorneys.”<sup>15</sup> The court made a distinction in the risk management documents between those that included individual case reserve figures and those that discussed only the aggregate reserves:

Although the risk management documents were not themselves prepared in anticipation of litigation, they may be protected from discovery to the extent that they disclose the individual case reserves calculated by Searle’s attorneys. *The individual case reserve figures reveal the mental impressions, thoughts, and conclusions of an attorney in evaluating a legal claim. By their very nature they are prepared in anticipation of litigation and, consequently, they are protected from discovery as opinion work-product.* We do not believe, however, that the aggregate reserve information reveals the individual case reserve figures to a degree that brings the aggregates within the protection of the work-product doctrine. The individual figures lose their identity when combined to create the aggregate information. Furthermore, the aggregates are not even direct compilations of the individual figures; the aggregate information is the product of a formula that factors in variables such as inflation, further diluting the individual reserve figures. Certainly it would be impossible to trace back and uncover the reserve for any individual case, and it would be a dubious undertaking to attempt to derive meaningful averages from the aggregates, given the possibility of large variations in case estimates for everything from frivolous suits to those

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<sup>13</sup> 134 F.3d 1194, 1203 (2nd Cir. 1998) (*quoting* WRIGHT & MILLER 8 FEDERAL PRACTICE & PROCEDURE § 2024, at 343 (1994)).

<sup>14</sup> One commentator recently made the following observation: “Litigation reserves ... sometimes have and sometimes have not been accorded work-product protection. The only apparent principle is that the litigation reserves established by public companies seem to be more likely to be held discoverable, presumably on the theory that financial matters must be transparent in such publicly held companies.” EDNA SELAN EPSTEIN, THE ATTORNEY-CLIENT PRIVILEGE AND THE WORK-PRODUCT DOCTRINE, 965 (American Bar Ass’n, 5th ed. 2007). But, a thorough review of the case law (including the cases cited by Ms. Epstein) reveal no cases that have refused to protect the purest form of litigation reserves — those expressing counsel’s mental impressions on an individual case. The case cited by Ms. Epstein for the opposite conclusion protected individual case reserves, but refused to protect aggregate case reserves. See *SEC v. R.J. Reynolds Tobacco Holdings, Inc.*, No. 03-1651, 2004 U.S. Dist. Lexis 24545, \*24 (D. D.C. June 29, 2004). Interestingly, that case stated, in dicta (and without any support), that if the doctrine did apply to aggregate case reserves that it was waived by disclosure to an auditor—a position that has been almost universally rejected by other courts.

<sup>15</sup> 816 F.2d 397, 401 (8th Cir. 1987).

with the most serious injuries. The purpose of the work-product doctrine—that of preventing discovery of a lawyer’s mental impressions—is not violated by allowing discovery of documents that incorporate a lawyer’s thoughts in, at best, such an indirect and diluted manner. Accordingly, we hold that the work-product doctrine does not block discovery of Searle’s risk management documents or the aggregate case reserve information contained therein.<sup>16</sup>

Likewise, in *Frank Betz Associates v. Jim Walter Homes, Inc.*, a court considered a defendant’s financial statements that listed the specific amount of reserve set aside for that particular lawsuit.<sup>17</sup> Although the court did not expressly employ the “because of” test, it explained that “[t]he reserve figures set for an individual case reflects an attorney’s professional opinion as to the value of the tort claimant’s suit ... [a] typical example[] of opinion work-product.”<sup>18</sup>

Again, in *Lawrence E. Jaffe Pension Plan v. Household International, Inc.*, the Northern District of Illinois applied the “because of” standard when considering the following litigation reserve information: “(1) opinion letters summarizing pending and threatened litigation against Household and its subsidiaries, written by ... Household’s ... general counsel; (2) internal [accounting firm] Memos to File, based largely on the contents of the Opinion Letters ...; and (3) draft and final internal Household letters written by and/or to internal Household counsel requesting and detailing the process for creating the Opinion Letters.”<sup>19</sup> The court expressly considered and rejected a narrower test for work-product:

This court agrees that documents are protected by the work-product privilege if they were prepared or obtained “because of” the prospect of litigation. In the court’s view, the position set forth in *El Paso, Gulf Oil*, and *Medinol* that the primary motivating purpose for creating the document must be to “aid in litigation” is overly narrow and contradictory to the principles underlying the work-product doctrine. Plaintiffs are correct that documents created in the ordinary course of business do not qualify for protection. *The audit letters at issue here, however, are not mere business documents.*<sup>20</sup>

The 1st, 2nd, 3rd, 4th, 6th, 7th, 8th, 9th, 10th, and DC Circuits all apply the “because

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<sup>16</sup> *Id.* at 401-402.

<sup>17</sup> 226 F.R.D. 533 (D.S.C. 2005).

<sup>18</sup> *Id.* at 534 (*quoting In re Pfizer Inc. Sec. Litig.*, No. 90-civ-1260, 1994 WL263610 (S.D.N.Y. June 6, 1994)).

<sup>19</sup> 237 F.R.D. 176, 178-79 (N.D. Ill. 2006).

<sup>20</sup> *Id.* at 181 (emphasis added and internal citations omitted).

of” test.<sup>21</sup> Examples where litigation reserves were protected under this test are myriad and are the clear majority position.<sup>22</sup>

A small minority of courts apply the narrower “primary purpose” test—a test that arguably does not protect litigation reserves. For instance, in *United States v. The El Paso Co.*, the Fifth Circuit wrote: “Litigation need not be imminent ... as long as the *primary motivating purpose* behind the creation of the document was to aid in possible future litigation.”<sup>23</sup> Here, the Fifth Circuit denied work-product protection to “tax pool analysis” documents and supporting memoranda summarizing “El Paso’s contingent liability for additional taxes should it ultimately be determined that El Paso owed more taxes than indicated on its return” because “the work was not *primarily motivated to assist in future litigation* over the return[s].”<sup>24</sup>

It is not clear whether the logic of *Davis* and *El Paso* still apply in the 11th Circuit.<sup>25</sup> Although the 11th Circuit has not directly considered the matter, its various district courts have struggled to reconcile *Davis* with the fact that virtually all other courts apply the more-

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<sup>21</sup> E.g. *United States v. Textron Inc.*, 507 F. Supp. 2d 138 (D. R.I. 2007) (granting work-product protection to “tax accrual workpapers” that include “estimates by Textron’s counsel expressing, in percentage terms, their judgments regarding Textron’s chances of prevailing in any litigation over [taxation issues] ... and the dollar amounts reserved to reflect the possibility that Textron might not prevail in such litigation.”); *Certain Underwriters at Lloyd’s London v. Fidelity and Cas. Ins. Co.*, No. 89-c-876, 1998 WL142409, \*2 (N.D. Ill. Mar. 24, 1998) (reserve recommendations set by insurance executives were protected under work-product because they “reveal attorney mental impressions, thoughts, and conclusions since the reserve figures were calculated only after an attorney acting in his legal capacity carefully determined that merits and value of the underlying case.”); *Nicholas v. Bituminous Cas. Corp.*, 235 F.R.D. 325, 332 (W.D. W. Va. 2006) (loss reserve information is protected work-product); *Harper v. Auto-Owners Ins. Co.*, 138 F.R.D. 655, 675 (S.D. Ind. 1991) (ordering that information regarding an established reserve be redacted from production); *In re Pfizer Inc. Sec. Litig.*, No. 90-civ-1260, 1994 WL263610 (S.D.N.Y. June 6, 1994).

<sup>22</sup> See also generally Andrew Golodny, *Lawyers Versus Auditors: Disclosure to Auditors and Potential Waiver of Work-Product Privilege* in *United States v. Textron*, 61 TAX LAW. 621 (American Bar Ass’n, Winter 2008) (discussing the policy considerations supporting the *Textron* decision.)

<sup>23</sup> 682 F.2d 530, 542-43 (5th Cir. 1982) (quoting *United States v. Davis*, 636 F.2d 1028, 1040 (5th Cir. 1981)).

<sup>24</sup> *El Paso*, 682 F.2d at 532, 543 (emphasis added).

<sup>25</sup> *El Paso* was decided in 1982. *Davis*, however, was decided on February 12, 1981 and is still theoretically binding in the 11th Circuit. See *Bonner v. Prichard*, 661 F.2d 1206 (11th Cir. 1981) (adopting Fifth Circuit law prior to September 31, 1981, as binding on the Eleventh Circuit).

inclusive “because of” standard.<sup>26</sup> For example, the Southern District of Florida recently found a way to apply the “because of” standard in the face of the 11th Circuit’s silence and the lingering precedent of the *Davis*-style “primary purpose” reasoning.

The work-product doctrine protects otherwise discoverable “documents and tangible things... prepared in anticipation of litigation or for trial by or for [a] party or by or for that ... party’s representative (including the ... party’s ... consultant ...).” Such materials, however, are not protected if they are assembled in the ordinary course of business or other non-litigation purposes. Documents are prepared in anticipation of litigation, and consequently protected by the work-product doctrine, if “in light of the nature of the document and the factual situation in the particular case, the document can fairly be said to have been prepared or obtained *because of* the prospect of litigation.” Although the Eleventh Circuit has not specifically adopted this formulation, it has been adopted in a significant majority of other circuits. “When there is a true independent purpose for creating a document, work-product protection is less likely, but when two purposes are profoundly interconnected, the analysis is more complicated.” A document is protected by the work-product doctrine if, “taking into account the facts surrounding their creation, their litigation purpose so permeates any non-litigation purpose that the two purposes cannot be discretely separated from the factual nexus as a whole.” In other words, *even if a document has some purpose within the ordinary course of business, the document is protected as work-product if it is substantially infused with litigation purpose.*<sup>27</sup>

This hybrid position—where the district court is obviously inclined to protect these documents under the work-product doctrine—is common throughout the 11th Circuit’s

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<sup>26</sup> See *Maine v. United States DOI*, 298 F.3d 60, 68 (1st Cir. 2002); *United States v. Adlman*, 134 F.3d 1194, 1202 (2nd Cir. 1998); *In re Grand Jury Proceedings*, 604 F.2d 798, 803 (3rd Cir. 1979); *Nat’l Union Fire Ins. Co. v. Murray Sheet Metal Co.*, 967 F.2d 980, 984 (4th Cir. 1992); *United States v. Roxworthy*, 457 F.3d 590, 593 (6th Cir. 2006) (“Today we join our sister circuits and adopt the ‘because of’ test as the standard for determining whether documents were prepared ‘in anticipation of litigation.’”); *Binks Manufacturing Co. v. Nat’l Presto Indus., Inc.*, 709 F.2d 1109, 1118-19 (7th Cir. 1983); *Simon v. G.D. Searle & Co.*, 816 F.2d 397, 401 (8th Cir. 1987); *In re Grand Jury Subpoena*, 357 F.3d 900, 908 (9th Cir. 2003); *Puerto Rico v. USDOJ*, 823 F.2d 574, 587 (D.C. Cir. 1987). Although most states do not use the same terminology, it appears that the “because of” test prevails in the state courts as well. See, e.g., *Carlton Investments v. TLC Beatrice Int’l Holdings*, No. 13950, 1996 Del. Ch. Lexis 111, \*4 (Del. Chancery Court September 17, 1996); *Medford v. Duggan*, 732 A.2d 533, 537 (N.J. 1999); *Raffa v. Gymnastics Learning Ctr. Inc.*, 14 Mass. L. Rep. 302 (Mass. 2002).

<sup>27</sup> *Developers Surety and Indem. Co. v. Harding Vill., Ltd.*, No. 06-21267-civ, 2007 U.S. Dist. Lexis 49994, \*5 & n.1 (S.D. Fla. July 11, 2007) (emphasis added and internal citations omitted).

district courts.<sup>28</sup>

While the “because of” test is the clear majority position, some state courts have not been consistent or precise in articulating which test they are applying. Alabama is an example where the court in December 2007 clearly used the “because of” test but without discussing a 2001 case using the primary purpose test.<sup>29</sup> Presumably the 2007 opinion controls (which also relies heavily on cases from the Seventh Circuit, which has long employed the “because of” test).<sup>30</sup>

Thus, it appears that litigation reserves will be protected as work-product doctrine in almost any jurisdiction—provided that the documents actually contain or reflect the lawyer’s evaluation of the underlying case or cases. The chief exception to this rule is the Fifth Circuit, which still uses the “primary purpose” test. It might be hard to argue that the primary purpose of a litigation reserve document was to aid in trial preparation, but, the Fifth Circuit has never directly considered this matter. The Court came close when it considered tax accrual documents in *El Paso*, but those documents may be distinguishable from litigation reserves, and the Fifth Circuit’s analysis focused mainly on the fact that the documents were prepared by accountants (not lawyers) for a pressing tax/financial concern without the aid of litigation attorneys.<sup>31</sup> Furthermore, some courts have characterized the relevant portions of *Davis* (the Fifth Circuit case upon which *El Paso* relies) as dicta.<sup>32</sup> Accordingly, the modern Fifth Circuit may be receptive to an argument that it should conform to the great weight of authority and protect litigation reserves under the work-product doctrine.

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<sup>28</sup> *E.g., United States v. Gericare Medical Sup. Inc.*, No. 99-0366, 2000 U.S. Dist. Lexis 19662, \*7 (S.D. Ala. Dec. 11, 2000) (criticizing and noting that *Davis* is “in tension” with other circuits and with other 5th Circuit precedent—but, ultimately concluding that the disputed documents were worthy of work-product protection “even assuming” that the primary purpose standard applies); *Friermuth v. PPG Indus., Inc.*, 218 F.R.D. 694, 700 (N.D. Ala. 2003) (“Courts differ on the standard triggering work-product protection ... If the court were to apply the ‘primary purpose’ standard, defendant’s assertion of the privilege would fail ... [but] the court need not decide whether the “primary purpose” standard is the appropriate standard because [other reasons indicating the disputed documents were not prepared in anticipation of litigation.]”); *Gutter v. E.I. DuPont de Nemours & Co.*, No. 95-2152-CIV, 1998 U.S. Dist. Lexis 23207 (S.D. Fla. May 18, 1998) (The court did not identify a particular test, but it protected litigation reserve documents that would arguably fail under *Davis*, saying: “Some of the documents contain information about liability reserves set aside to respond to a possible adverse judgment or settlement. Both parties agree that aggregate reserves are not protected from discovery since they serve mainly business purposes. Such information is considered to be too generalized to be useful for planning litigation strategy in any specific case, and therefore such aggregate reserve figures do not constitute work-product ... On the other hand, documents which contain individual reserve figures are protected work-product because they reflect an attorney’s professional opinion about the value of a particular lawsuit.”).

<sup>29</sup> *Compare Ex parte Meadowbrook*, No. 1061493, 2007 Ala. Lexis 280, \*18 (Ala. December 21, 2007) (“The inquiry ‘should be whether, in light of the nature of the document and factual situation in the particular case, the document can fairly be said to have been prepared or obtained because of the prospect of litigation.’”) (emphasis in original) with *Ex parte Cryer*, 814 So. 2d 239 (Ala. 2001) (“While litigation need not be imminent, the *primary motivating purpose* behind the creation of a document or investigative report must be to aid in possible future litigation.”) (emphasis added).

<sup>30</sup> *See, e.g., Binks Manufacturing Co. v. Nat’l Presto Indus., Inc.*, 709 F.2d 1109, 1118-19 (7th Cir. 1983).

<sup>31</sup> *See El Paso* 682 F.2d at 534-35.

<sup>32</sup> *See Adlman*, 134 F.3d at 1198; *accord Gericare Medical Supply*, 2000 US Dist. Lexis 19662 at \*6-7.

**Part II – Protecting the Litigation Reserves After Disclosure**

An equally compelling issue is deciding whether the protections afforded to litigation reserves will persist after the reserves are disclosed to others inside or outside of a corporation.

***A. Disclosure to Outside Auditors — Waives Attorney-Client Privilege But Not Work Product***

In order to comply with the Securities Exchange Act and the Sarbanes-Oxley Act corporations must frequently reveal the amount of, and rationale behind, their litigation reserves to independent outside auditors. Regardless of the reason, there is little doubt that this disclosure waives any protection afforded by the attorney-client privilege. One example among many is the *Textron* case, where the federal district court for Rhode Island wrote: “In short, any attorney-client privilege ... that attached [to the tax accrual workpapers] was waived when Textron provided its workpapers to [Earnst & Young].”<sup>33</sup> Thus, any hope for protecting litigation reserves that have been disclosed to outside auditors rests in the work-product doctrine.

The shield of work-product is more durable than that of privilege. The key to preserving the work-product protection after disclosure is that the disclosure must not have been to a “potential adversary.”<sup>34</sup> In fact, “[m]ost courts have held that disclosure of information to an independent auditor does not waive the work-product privilege because it does not substantially increase the opportunity for potential adversaries to obtain the information.”<sup>35</sup>

For example, in *United States v. MIT*, the First Circuit recognized that work-product protection is difficult to waive but nevertheless held that it was waived when MIT disclosed its protected documents to government auditors.<sup>36</sup> Because MIT’s current opponent (the IRS) and its auditor (the DOD) were related (in that they were both government agencies) the court held that the earlier disclosure to the DOD auditors greatly increased the chance of MIT’s opponents obtaining the protected information—thus, the protection was waived.<sup>37</sup>

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<sup>33</sup> 507 F. Supp. 2d at 152.

<sup>34</sup> Unlike privilege, where the emphasis is on confidentiality, “the purpose of the work-product privilege is to prevent a potential adversary from gaining an unfair advantage over a party by obtaining documents prepared by the party or its counsel ... which may reveal the party’s strategy or the party’s own assessment of the strengths and weaknesses of the case.” *Id.*

<sup>35</sup> *Id.*; accord *Frank Betz and Assocs. Inc.*, 226 F.R.D. at 535 (“[T]his court finds that the reserve amount is protected by the work-product doctrine and was not waived by the disclosure of the amount to outside auditors.”); *Jaffe Pension Plan*, 237 F.R.D. at 183; *Gutter*, 1998 US Dist Lexis 23207 at \*5.

<sup>36</sup> 129 F.3d 681, 687 (1st Cir. 1997).

<sup>37</sup> *Id.*

An ordinary outside auditor—*i.e.* an accounting firm hired as an independent outside auditor for purposes of complying with reporting requirements—is generally not considered a potential adversary or a conduit to a potential adversary. Thus, disclosure to an outside auditor does not waive work-product protection. For instance, in *Jaffe Pension Plan*, one federal district court wrote: “[T]he fact that an independent auditor must remain independent from the company it audits does not establish that the auditor also has an adversarial relationship with the client as contemplated by the work-product doctrine. *Disclosing documents to an auditor does not substantially increase the opportunity for potential adversaries to obtain the information.*”<sup>38</sup> Note, however that there is a clear minority position which holds that outside auditors are adversaries and therefore disclosure waives work-product protection.<sup>39</sup>

Thus, litigation reserves disclosed to a corporation’s outside auditors should remain protected by the work-product doctrine.

### ***B. Internal Auditors – No Waivers***

If work-product protection is not waived by disclosure to an outside auditor, then disclosure to an internal auditor will definitely not cause a waiver. Significantly, though, the attorney-client privilege may also remain intact after the reserves are disclosed to an internal auditor.

“Voluntary disclosure to a third party waives the attorney-client privilege even if the third party agrees not to disclose the communications to anyone else.”<sup>40</sup> This quite obviously applies to disclosures made to independent auditors.<sup>41</sup> A corporation’s internal

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<sup>38</sup> 237 F.R.D. at 183 (Emphasis added); *accord Pfizer*, 1993 U.S. Dist. Lexis 18215, at \*6 (no waiver of work-product protection because auditor “not reasonably viewed as a conduit to a potential adversary.”); *In re JDS Uniphase Corp. Sec. Litig.*, 2006 U.S. Dist Lexis 76169 (N.D. Cal. 2006); *Merrill Lynch Co. Inc. v. Allegheny Energy, Inc.*, 229 F.R.D. 441, 448 (S.D.N.Y. 2004) (auditors were not adversaries therefore, disclosure of report of investigation results by in-house counsel was not a waiver of the work-product protection; “business and its auditor can and should be aligned insofar as they both seek to prevent, detect and root out corporate fraud”); *International Design Concepts, Inc. v. Saks Inc.*, 2006 WL 1564684 (S.D.N.Y. June 6, 2006); *American Steamship Owners Mut. Prot. & Indem. Ass’n v. Alcoa Steamship Co., Inc.*, 2006 WL 278131 (S.D.N.Y. Feb. 2, 2006); *Gutter*, 1998 US Dist Lexis 23207 at \*5.

<sup>39</sup> These minority cases (holding that an accountant is an adversary) are contrary to the clear majority trend. *See SEC v. R.J. Reynolds Tobacco Holdings, Inc.*, No. 03-1651, 2004 U.S. Dist. Lexis 24545, \*24-25 (D. D.C. June 29, 2004) (“Even if the aggregated forecasted costs were to be considered fact work-product, that information would still be subject to disclosure ... on the basis of waiver due to RJR’s disclosure of these aggregated forecast numbers to RJR’s outside auditors.”) (stated in dicta and without support); *Medinol, Ltd. V. Boston Scientific Corp.*, 214 F.R.D. 113, 116 (S.D.N.Y. 2002) (waived work-product by providing board minutes to auditors which included investigation conducted by outside counsel: “[auditors] must not share common interests with the companies they audit”) (emphasis in original); *In re Raytheon Sec. Litig.*, 218 F.R.D. 354 (D.Mass. 2003).

<sup>40</sup> *Westinghouse Elec. Corp. v. Republic of the Philippines*, 951 F.2d 1414, 1427 (3rd Cir. 1991).

<sup>41</sup> *See Pfizer*, 1993 U.S. Dist. Lexis 18215 at \*7 (“Disclosure of documents to an outside accountant destroys the confidentiality seal required of communications protected by the attorney-client privilege.”); *Gutter*, 1998 US Dist Lexis 23207 at \*5.

auditors, however, should not be a “third party.”<sup>42</sup>

Asserting the attorney-client privilege to reserves disclosed to internal auditors is by no means a sure thing. But, if successfully asserted, it affords the corporation an absolute privilege which cannot be defeated by a showing of need and hardship—unlike the work-product protection. Of course, it is hard to imagine how a litigant could demonstrate a genuine need for an opponent’s litigation reserve or how he would be prejudiced by not having access to the reserve figures. It is generally accepted that the only reason litigants seek to obtain reserve information is for a “sneak peek” at their opponent’s valuation of their own position in the case to see how far they might push in settlement negotiations or gauge how serious the corporation is about taking a matter to trial. For instance, the federal district court for Rhode Island noted in *Textron*: “Textron argues that the IRS seeks the documents for the purpose of using them as leverage in settlement negotiations.”<sup>43</sup>

### *C. Disclosure to a Parent Corporation — No Waiver*

If litigation reserves are disclosed to a parent corporation, both the attorney-client privilege and the work-product doctrine likely remain intact. The major exception to this statement, of course, is if the two corporations were to become legal opponents. In the ordinary course of a parent/subsidiary relationship—for example, if the subsidiary is required to justify the amount of its litigation reserve to its parent corporation during an annual review—the two corporations will not be adverse. For instance, in *Glidden Co. v. Jandernoa*, a federal district court in Michigan wrote: “The universal rule of law, expressed in a variety of contexts, is that the parent and subsidiary share a community of interest such that the parent (as well as the subsidiary) is the ‘client’ for purposes of the attorney-client privilege.”<sup>44</sup>

Again, maintaining these protections here is by no means a sure thing—there is little or no case law addressing such disclosures of litigation reserves. But, given the foregoing analysis, disclosure should not waive either the privilege or work-product protection.

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<sup>42</sup> See, e.g., *SCM Corp. v. Xerox Corp.* 70 F.R.D. 508, 518 (D. Conn. 1976) (“A privileged communication should not lose its protection if an executive relays that legal advice to another who shares responsibility for the subject matter underlying the consultation.”); *James Julian, Inc. v. Raytheon Co.*, 93 F.R.D. 138, 141-42 (D. Del. 1982) (“The fact that some unauthorized corporate personnel may purposely or inadvertently read a privileged document does not render that document nonconfidential.”); see also generally EDNA SELAN EPSTEIN, THE ATTORNEY-CLIENT PRIVILEGE AND THE WORK-PRODUCT DOCTRINE, 175 & 486 (American Bar Ass’n, 5th ed. 2007) (“What constitutes an acceptable client representative for privilege purposes has, on occasion, been expanded to include non-employees and even independent contractors who are authorized to act on the [corporation’s] behalf with respect to a particular matter.”)

<sup>43</sup> 507 F. Supp. 2d at 144.

<sup>44</sup> 173 F.R.D. 459, 472 (W.D. Mich. 1997); accord *In re Sulfuric Acid Antitrust Litig.*, 2006 U.S. Dist. Lexis 20086 (N.D. Ill. Apr. 10, 2006) (No waiver where privileged documents were shared between two corporations, where one owned 46% of the stock in the other and maintained effective control by appointing its board of directors.)

**Part III – Practical Suggestions for Preserving Protection**

***A. Treat All Communication Regarding Litigation Reserves as Confidential***

By definition, this is an absolute necessity in order to assert the attorney-client privilege. Although not necessary to gain work-product protection, an air of confidentiality may persuade the court to uphold a claim of work-product when litigation reserves have been shared outside of the corporation. For instance, the *Textron* court held that disclosure did not waive work-product because “the disclosure of Textron’s tax accrual workpapers to E&Y did not substantially increase the IRS’s opportunity to obtain the information contained in them ... [because] E&Y had a professional obligation ‘not to disclose’ ... [and] E&Y expressly agreed not to provide the information to any other party, and confirms that it has adhered to its promise.”<sup>45</sup>

***B. Work with Auditors to Limit Disclosure Requested***

Counsel should discuss with auditors exactly what they need when a broad request for reserves or litigation status is received. It is almost always possible to narrow what is requested and perhaps the auditor will be satisfied with a description of the facts rather than an assessment. Because accountants have, to some extent, lost control of what they must review in order to provide an unqualified opinion, they are far less willing today to accept explanations that would have sufficed in the past.<sup>46</sup> However, their questions need not include mental impressions of counsel—at least not in every circumstance.

***C. Obtain Agreement of Auditors that Materials are Confidential***

If disclosures must be made, attempt to obtain an agreement from the auditor that it is being provided under an agreement that it will be kept confidential and for the limited purpose of the audit engagement.

***D. Limit Any Disclosure Made***

If disclosures must be made, attempt to obtain an agreement from the auditor that it

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<sup>45</sup> 507 F. Supp. 2d at 153.

<sup>46</sup> The Sarbanes-Oxley Act of 2002 established the Public Company Accounting Oversight Board (“PCAOB”) to oversee auditing of public companies. The PCAOB has the power to establish rules for audits and audit reports and may discipline and investigate accounting firms. The tension between accounting firms and the legal community about what was required for loss contingencies was mostly resolved by the “Treaty” reached in 1975 between the ABA and the American Institute of Certified Public Accountants (which formerly appeared to have similar but lesser powers). However, the PCAOB has not adopted the Treaty and at least some comments have appeared to indicate opposition to portions of the Treaty. The future of the “Treaty” is beyond the scope of this article but could also increase the importance of the waiver issues discussed above.

is being provided under an agreement that it will be kept confidential and for the limited purpose of the audit engagement.

### ***E. Provide a Verbal Explanation***

It may also be possible to provide a verbal explanation rather than a written explanation. This may assist in limiting any disclosure, including limiting what is exactly stated—as well as limiting who receives it. Note, however, that many auditors document in detail such conversations with attorneys, and some opposing attorneys have made attempts to subpoena such notes. Further, there has been considerable pressure placed on accountants to better document statements from legal counsel to relating to loss contingencies.<sup>47</sup> Nevertheless, for disclosure purposes, verbal is likely safer than written.

### ***F. Provide Pre-Existing Documents***

If documents must be provided to accountants, it is best that they not be specifically created for the accountant. In other words, the argument that they were created “in anticipation of litigation,” can be damaged if they were created specifically for a meeting or disclosure to an accountant.

### ***G. Label***

If the disclosures are on paper or electronic, they should be labeled clearly and repeatedly in the document (every page if possible).

### ***H. Be Specific***

The more that litigation reserve documents are tied to an attorney’s impression or opinion of a particular case, the greater the chances that document will be protected under the work-product doctrine.<sup>48</sup> This principle results in a sort of “Catch-22”—the best way to invoke work-product protection for a litigation reserve document is to include in it the juiciest of information; the thoughts, impressions, and theories of the trial counsel that justify the amount reserved for a particular case. The risk, of course, is that if the court

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<sup>47</sup> See, e.g., Report on 2003 Limited Inspection of Deloitte & Touche LLP issued by the Public Company Accounting Oversight Board (August 26, 2004); Scott A. Taub, Deputy Chief Accountant, U.S. Securities and Exchange Commission, *Remarks at the University of Southern California Leventhal Scholl of Accounting SEC and Financing Reporting Conference* (Los Angeles, California, May 27, 2004).

<sup>48</sup> See, e.g., *SEC v. R.J. Reynolds Tobacco Holdings, Inc.*, No. 03-1651, 2004 U.S. Dist. Lexis 24545, \*24 (D. D.C. June 29, 2004) (Protecting “forecasted costs of litigation that are broken down on a case-by-case basis,” but denying protection to “aggregated forecasted costs.”); *Gutter v. E.I. DuPont de Nemours & Co.*, No. 95-2152-CIV, 1998 U.S. Dist. Lexis 23207 (S.D. Fla. May 18, 1998) (same distinction); *Simon v. G.D. Searle & Co.*, 816 F.2d 397, 401 (8th Cir. 1987) (same).

doesn't agree that the documents deserve work-product protection, the opponents will gain access to the things they covet most.

It is impossible to provide a one size fits all rule for disclosure; however the risk is likely small that a court would order the production of true mental impressions of counsel. As discussed above, current case law does not reveal a single case that refused to protect the direct opinion of counsel regarding the valuation of an individual case. There are numerous examples, however, of courts ordering the production of aggregate reserve amounts—under the theory that it is not possible to “reverse engineer” the corporate counsel's opinions on the individual cases. If a document is very specific and happens to include both types—individual case reserves and an aggregate reserve—then the worst likely outcome is that the corporation might be ordered to produce a redacted version of the document that strikes the individual reserves and opinions.

### Conclusion

Despite the best efforts of aggressive litigants, litigation reserves are probably protected as attorney work-product, or under the attorney-client privilege, or both. Even after disclosure to an independent outside auditor, litigation reserve information is probably still protected by the work-product doctrine. If disclosed to internal auditors or to a parent corporation, the reserve information is probably still protected by both the work-product doctrine, and as privileged attorney-client communications.

The most dangerous jurisdiction for litigation reserve information is the Fifth Circuit, which still applies the antiquated “primary purpose” test to determine whether work-product was generated “in anticipation of litigation.” But, the Fifth Circuit has not expressly denied work-product protection to litigation reserves, and may be receptive to a careful argument for their protection. Moreover, all such discovery requests should be met with an objection under F.R.C.P. 26(b)(1) for relevancy and 26(b)(2)(c) for balancing the burden and benefit.



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